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U.S. Financial Reform: Historical Perspective

Speculation on whether the 99th Congress will enact banking legislation has been running high for the past year. It now appears that tax reform, the federal deficit, and the trade deficit will take precedence, but this does not mean that further banking legislation and other reforms are not needed.

Senator Jake Garn of Utah, commenting on the possibility of further banking legislation, stated that the environment of crisis that propelled the 1980 Deregulation and Monetary Control Act and the 1982 Garn-St Germain Depository Institutions Act into law is no longer present. The fact that financial reform is not expected this year because of the lack of a crisis is not unique to the current period in our economic history. The crisis-orientation of reform is clearly evident from a review of the financial history of the U.S.

An outstanding example is the 1930-33 period when over 10,000 banks failed. In response, President Roosevelt called a national bank holiday in March 1933. Eventually, the financial system was subjected to the most extensive restructuring since the birth of the nation. The structure of institutions, markets, and regulation that emerged persisted until the late 1970s, when a new crisis threatened the financial system and generated another round of financial reform that has yet to be completed.

This *Letter* places the current financial reform process in a historical context by describing and comparing the content and objectives of the reforms of the 1930s with those of the 1980s. The Great Depression profoundly affected our economy, and only by understanding how it influenced the financial system can we fully understand the current reforms.

Financial reform in the 1930s

The reforms of the 1930s came in the wake of what is regarded by many as the most serious disruption of financial and real economic activity ever experienced in the U.S. — the Great Depression. These reforms established the structure of the financial system until the late 1970s, and reflected a dramatic change in philosophy away from a belief in an unregulated market system. The reforms sought to establish a stable financial system by restraining bank competition and by significantly expanding federal supervision and regulation to banks and to other financial institutions and markets. They also strengthened and centralized Federal Reserve control over money and credit.

This effort to establish a more stable financial system had four main components. The first was the effort to limit the scope for risk taking in the interest of restraining what were perceived at the time to be "unsound" banking practices. Regulation Q and Q-type interest rate ceilings on savings and time deposits limited banks' ability to use explicit deposit pricing to compete. An outright ban on banks paying interest on demand deposits was also established. In addition, constraints on entry into banking and restrictions on bank lending and investment activities were imposed in the hope of fostering safer banking practices. Nevertheless, whatever the intent of these measures, their effect in many instances tended to limit the amount of competition in banking.

Banks were the main focus of these restrictions because of their dominant role in financial intermediation, however, analogous restrictions were placed on other institutions as they expanded after World War II. Savings and loans (S&Ls), for example, were not permitted to offer checking accounts, business loans, or consumer loans, although, at the same time, regulation did favor thrifts by allowing them to pay a ¼ percentage point more on savings and small time deposits. While portfolio restrictions on thrifts had other objectives, such as supporting the housing industry, their effect in many instances was to limit thrifts' competitive position especially relative to the open market.

Second, the Federal Deposit Insurance Corporation (FDIC) was formed to insure the deposits of banks and savings banks in an effort to restore public confidence in the banking industry. Federal deposit insurance was also established for S&Ls at the same time. Third, the powers of existing federal regulatory agencies were expanded and several new regulatory agencies were established to regulate and supervise financial institutions and markets. These agencies adopted many policies that, whatever their intent, are viewed by many observers to have limited competition. Fourth, the Federal Reserve System was reorganized to give the Board of Governors a larger role in System decisionmaking. The Board's powers to control money and credit also were enhanced.

To understand the focus of the reform effort, one must consider the then-popular view that the collapse of the banking system occurred because banks had adopted risky loan and investment strategies that made them susceptible to collapse in the face of any major adverse economic event. In addition, bank competition for funds was blamed for driving up the cost of their deposits. As a result, the argument went, they became involved in equity, bond, and real estate markets to a degree far in excess of that prudent for institutions whose deposits constituted the major part of the country's money supply. The reforms of the 1930s were based on the idea that banks played too important a role in the economy to be left unregulated, and that the free play of competitive forces only encouraged banks to assume a level of risk ultimately unsound for the financial system and the economy.

The shift in attitude toward regulated financial markets and limited competition was part of a much broader shift in attitude about the market system and the role of government. After the Great Depression, the market system was no longer expected automatically to achieve an efficient allocation of resources and full employment. Instead, skepticism toward market solutions prevailed. The extensive increase in financial regulation and supervision reflected in the financial legislation of the 1930s was one of the outcomes of this skepticism.

Emergence of a crisis in the late 1970s

The financial system performed at a satisfactory level until the mid-1960s when it began to show signs that it was incompatible with current economic conditions. Of the many structural problems that emerged, Regulation Q ceilings on deposit rates and portfolio constraints on institutions (primarily thrifts) that specialized in mortgage lending were especially important.

Regulation Q was extended to S&Ls and savings banks in 1966 and encouraged substantial losses of deposits from banks, S&Ls, savings banks, and credit unions whenever market interest rates rose significantly above Regulation Q ceilings. Depositors shifted their funds to investments with unregulated rates in what is referred to as "disintermediation." Since depository institutions were the major suppliers of consumer and mortgage credit, disintermediation also reduced the availability of credit for the household sector.

The thrift problem arose from the highly constrained nature of the portfolios of S&Ls and savings banks. Because of regulation, tax incentives, and tradition, thrifts allocated funds primarily to long-term fixed-rate mortgages. However, their sources of funds were becoming increasingly short-term and market-sensitive as interest rates rose and regulators authorized new deposits not subject to Regulation Q to prevent disintermediation. They found that their traditional strategy of financing their holdings of mortgages, which have long maturities, with mainly very short-term deposits put them in a difficult position when interest rates rose and became more volatile.

Structural problems in the financial system were first manifest in disintermediation and the thrift problem. However, basic economic developments were also recognized as exacerbating these problems. The upward trend in inflation since the mid-1960s fostered financial innovation as accompanying rising market interest rates made Regulation Q ceilings increasingly binding. These innovations in turn were seen by many observers as making the Fed's job of reining-in overly expansionary monetary growth more difficult. By the end of the 1970s, the structural problems in the financial system and the monetary control problems of the Federal Reserve were seen to be related and to require a simultaneous solution.

Financial reform in the 1980s

The crisis that started in late 1979 and early 1980 was responsible for the latest period of financial reform. Inflation rates of almost 20 percent per year, accelerating prices for gold and silver on speculative markets, declining dollar values on foreign exchange markets, the probable failure of Chrysler Corporation and concerns about the fragility of some banks all contributed to a mood of pessimism that ironically coincided with the fiftieth anniversary of the beginning of the Great Depression. The observance of that anniversary naturally invited comparison of the state of the banking system in the late 1970s with that in the 1930s.

Financial reform ensued on four fronts. First, the Federal Reserve System announced new operating procedures in October 1979 that would assist it in its longer-term strategy of lowering money growth to rates that were compatible with reasonable price stability. Second, the Federal Reserve announced new measures of the monetary aggregates that took into account the proliferation of new deposit and other instruments caused by financial innovation.

Third, the Deregulation and Monetary Control Act of March 1980 introduced the most significant structural changes in the financial system since the reform legislation of the 1930s. The Act expanded the sources of funds for all depository institutions by authorizing nationwide NOW accounts; it expanded S&Ls' uses of funds by authorizing consumer lending (up to 20 percent of assets); it allowed S&Ls to issue credit cards and to provide trust and related fiduciary services; it relaxed or removed state-imposed usury limits on mortgage and other types of credit; and, most importantly, the Act established a mechanism to phase out Regulation Q ceilings on savings and time deposits by March 1986. The legislation also extended reserve requirements to all depository institutions that offered a reservable deposit (transactions and nonpersonal time deposits) in an effort to improve Federal Reserve monetary control; allowed access to the discount window for all depository institutions with reservable deposits; extended access to Federal Reserve services to all depository institutions; and required the Fed to charge a fee for most of those services. Fourth, the Garn-St Germain Depository Institutions Act of October 1982 was passed to address the plight of S&Ls and savings banks. The 1982 Act authorized money market deposit accounts (MMDAs), encouraged the Deregulation Committee to introduce Super-NOW accounts, further diversified the powers of S&Ls, and settled the controversy over the due-on-sale clause in mortgage contracts.

These actions have made major changes in the structure of the financial system and the conduct of monetary policy. Their benefits include: (1) increased competition and, hence, greater efficiency in the transfer of funds between lenders and borrowers; (2) greater equity for the small saver, who can now earn market rates of interest; (3) increased incentives to save to support economic growth; (4) a more stable financial system, by ending periods of disintermediation and improving the viability of thrifts; and (5) greater monetary control by the Federal Reserve.

The reform process of the 1980s may not yet be complete. Many observers argue that there still remain the needs to restructure deposit insurance, to redefine geographic and product-line restrictions on banks and other financial institutions, and to remove the zero ceiling on demand deposits, as well as to permit nonbank banks to issue demand deposits. But in the absence of another crisis, the pace of further financial reform is uncertain.

The reforms of the 1930s and 1980s

The reform periods of the 1930s and 1980s stand out as major changes in the structure of the financial system when viewed against the background of the entire financial history of the U.S. There are important similarities and a major difference worth keeping in mind.

Both reform periods were crisis-oriented, although the more recent crisis was not as severe as the Great Depression. Each was concerned with enhancing the stability of the financial system and the soundness of depository institutions, and with aiding monetary control. And both represented extensive intervention by Congress and federal regulators.

Despite these similarities, there was a fundamental difference. The reforms of the 1980s were designed to expand the degree of competition in the financial system and, in fact, to dismantle a number of the key constraints established in the 1930s. Like the 1930s' reforms, the current reforms are part of a broader change in philosophy about the market system and the role of government. But unlike the earlier reforms, they represent newfound faith in market solutions that had been destroyed by the Great Depression.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 03/06/85	Change from 02/27/85	Change from 03/07/84	
			Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	188,737	425	12,087	6.8
Loans and Leases[1] [6]	170,989	337	14,453	9.2
Commercial and Industrial	52,939	189	5,598	11.8
Real estate	62,231	– 21	2,501	4.1
Loans to Individuals	32,752	35	5,703	21.0
Leases	5,285	10	273	5.4
U.S. Treasury and Agency Securities[2]	10,699	115	– 1,496	– 12.3
Other Securities[2]	7,049	– 27	– 867	– 10.9
Total Deposits	194,266	1,980	8,553	4.6
Demand Deposits	44,863	1,228	1,525	3.5
Demand Deposits Adjusted[3]	29,852	1,001	786	2.3
Other Transaction Balances[4]	13,576	799	1,110	8.9
Total Non-Transaction Balances[6]	135,827	– 47	5,922	4.5
Money Market Deposit Accounts—Total	43,895	112	3,371	8.3
Time Deposits in Amounts of $100,000 or more	38,909	– 262	860	2.2
Other Liabilities for Borrowed Money[5]	18,708	–2,502	– 654	– 3.3

Two Week Averages of Daily Figures	Period ended 02/25/85	Period ended 02/11/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	111	31
Borrowings	84	21
Net free reserves (+)/Net borrowed(–)	27	10

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change